Five Year Update on Sarbanes Oxley

Submitted by James Ingram in re: Discussion of Internal Auditor

Greg Farrell, "Sarbanes-Oxley Law Has Been a Pretty Clean Sweep, *USA Today*, July 30, 2007, p. 6B.

Investors who got a midsummer haircut last week during the Dow's 735-point drop from 14,000 probably aren't singing Happy Birthday for the Sarbanes-Oxley Act, which is 5 years old today. But maybe they should be.
If you think last week's sell-off was bad, recall the summer of 2002. Enron had imploded, WorldCom admitted to fabricating billions of dollars in earnings, and prosecutors were swirling around Tyco and Adelphia. From May 24 of that year to July 23, the Dow dropped from 10,104 to 7,702, a plunge of 24%.
That wasn't a haircut, or a correction. It was a full-blown crisis. The public, and even the White House, demanded action.

In response, Congress passed the Sarbanes-Oxley Act on July 30, 2002. The law forced public companies to spend much more money having their books thoroughly audited, and it increased the penalties for executives who defrauded investors. Since the bill's passage and implementation, nervous investors who had yanked trillions of dollars from the market have returned.

Yet now, despite the law's apparent success, some powerful members of the financial community have spoken out against it. The most prominent are U.S. Treasury Secretary Henry Paulson, New York Stock Exchange CEO John Thain and former AIG chief Maurice "Hank" Greenberg. All three have warned that the regulatory environment in the USA threatens its competitive position in the global marketplace.

But their voices appear to be isolated.

Charles Niemeier, a member of the Public Company Accounting Oversight Board (PCAOB) — which was created by Sarbanes-Oxley — says the law has been a huge success for the average investor.

"Instead of the sky falling, it's just the opposite," he says. "I see it as a clear, blue sky. We're in a better place today, but we're not willing to admit it."

"It's a terrific piece of legislation," says Chuck Bowsher, former U.S. controller general and a longtime accounting industry watchdog. "It's worked very well."

"We're in much better shape today than we were prior to Sarbanes-Oxley," says Harvey Goldschmid, who served as an SEC commissioner from 2002 to 2005. "The markets were in turmoil, corporations were in disrepute. There was a real fear that the lack of trust in the markets could create long-term problems."

Christopher Cox, the current SEC chairman, says, "Sarbanes-Oxley helped restore trust in U.S. markets by increasing accountability, speeding up reporting, and making audits more independent."

Like any landmark piece of legislation, Sarbanes-Oxley Act sparked controversy. From Corporate America as well as the nation's auditing firms, complaints poured in during the early days. But after the market digested the changes, the law wound up helping public companies vet their own financial statements.

"There is a universal recognition that Sarbanes-Oxley was hastily drafted and contained a number of questionable approaches, but on the whole, it has had a very beneficial effect," says Harvey Pitt, who was chairman of the SEC when the law was passed. "Public companies are paying a lot closer attention and doing a much better job."

Among other things, the law called for:

•The establishment of the PCAOB, a new panel in charge of regulating auditing firms, which up until 2002 had policed themselves.

•The strengthening of audit committees on the boards of directors of U.S. public companies.

•New responsibilities for a public company's CEO and chief financial officer. Beginning in August 2002, executives who signed off on their companies' financial statements would be held liable for the quality of those financial statements. They would no longer, in the eyes of the law, be able to claim they didn't understand what they were signing.

•Public companies to establish hotlines that would allow whistle-blowers to go around management and report alleged wrongdoing directly to a company's board of directors, without fear of retribution.

•Substantial increases in appropriations for the SEC, which had been underfunded through much of the 1990s.

William Donaldson, who became SEC chairman in 2003 and helped implement many of the law's proposals, cautions that it's too soon to measure the benefits of the law, nicknamed SOX. But in one area, he argues, the law is clearly working: Directors have begun to assert themselves in the boardroom.

"Corporate boards are working better," he says. "The responsibilities that should have been there all along, but got shifted to the CEO, are back in the board's hands, particularly with independent audit committees."

The country's biggest public companies, which already employed armies of internal accountants, were best positioned to adjust to the new law.

"I've been a vocal supporter," says Keith Sherin, chief financial officer of General Electric. "We got a benefit out of it; it hasn't been a burden."

But across the corporate landscape, not everyone praised the new law. In 2003 and 2004, detractors claimed that SOX would hamper merger activity and prevent venture capitalists from raising funds, two fears which proved unfounded.

The most serious challenge to the law took shape a year ago, after former Goldman Sachs CEO Henry Paulson became secretary of the Treasury. Soon after being sworn in to President Bush's Cabinet, Paulson gave a speech in which he expressed concern about regulatory restrictions on the marketplace. He warned that, "Often the pendulum swings too far, and we need to go through a period of readjustment."

Critics of the law seized on his remark as an affirmation of their belief that the legislation was an overreaction.

Weeks later, Greenberg, former CEO of AIG, echoed Paulson's remarks in an editorial that "the cost of government regulations has become unbearable." Greenberg funded a study that argued the hassles of shareholder litigation, along with excessive regulation, were pushing companies to list on foreign exchanges.

Last November, NYSE's Thain complained that overregulation of public companies in the USA was driving a greater percentage of initial public offerings into the arms of foreign exchanges.

But the PCAOB's Niemeier dismisses that, saying the only issue that should matter is whether U.S. investors can trust the financial statements of public companies. "Fraud has dropped to much lower levels than five years ago," he says. "Is litigation bad for business? Enron is bad for business."

As for the complaint that too many companies are opting to list on foreign stock markets, Niemeier argues that critics are missing the larger point: Companies that list in the USA get an extra bounce in their share prices because of the credibility of our regulatory system.

Niemeier says that an academic study shows companies listing on the NYSE or Nasdaq enjoy a premium of at least 15% over companies that list outside the USA. According to Andrew Karolyi, the Ohio State finance professor who spearheaded the study, the premium existed before Sarbanes-Oxley and continued after the law's passage.

What's more, Karolyi's data show that foreign firms that list in the USA are able to raise capital in their home markets on better terms.

"There's a governance benefit," Karolyi says, "a sheen that comes from listing in New York. You get a big boost from listing in New York, but that doesn't appear to be the case in London."

Section 404

While Sarbanes-Oxley has helped restore investor confidence in the marketplace, one element of the law has proved to be a big financial burden to small and midsize public companies.

Section 404 of the act, a short passage that almost looks as if it were added as an afterthought, directs managers at public companies to review and assess internal accounting controls each year.

That may sound simple enough, but the PCAOB's interpretation of this directive spawned a costly internal-review process that sent auditing fees into the stratosphere for midsize companies. In response to the outcry over the sudden rise in auditing costs, the SEC and PCAOB promised to devise a sliding scale that would alleviate some of the financial pain on midsize companies. And for at least one more year, public companies with a market capitalization of less than $75 million won't have to comply.

But the extra year's deferral is no solace to entrepreneurs such as Jim DeBello, CEO of software firm Mitek Systems. Mitek, which employs 40 and posts annual sales in the $6 million to $10 million range, would have to pay $600,000 to $1 million in auditing costs to comply with Section 404, DeBello says.

"We consider ourselves a well-run small business," he says. "We comply with all SEC requirements and consistently filed our quarterly statements."

But the cost of complying with Section 404, about 10% of annual revenue, was a "shock to us." With the $600,000 minimum he'd have to pay to comply with the SOX provision, DeBello says, he could hire four to six full-time employees. "That trickles down to employment, innovation and our ability to grow," he says. "We've made decisions not to add in order to afford the cost of doing the right thing."

To the U.S. Chamber of Commerce, Section 404 is the worst part of an otherwise useful law.

"We believe that it's the law of the land and it's got some benefits," says Michael Ryan of the Chamber of Commerce. "We're very concerned about the costs associated with Sarbanes-Oxley but feel that those costs can be addressed."

If the SEC and PCAOB can reduce the costs of Section 404 to a manageable level, Ryan says, all is well and good. But the time and energy required by SOX can be a distraction.

"There's an opportunity cost here," he says. "The amount of time management is spending on the process to comply with Sarbanes-Oxley takes them away from running the business, increasing sales and developing new products." Ryan also argues that SOX "runs the risk of creating a culture of avoiding risk, and that bleeds over from the issue of trying to eliminate wrongdoing."

Former senator Paul Sarbanes, the law's chief architect, who left office after his term ended in January, acknowledges that 404 and other elements of SOX have increased costs for public companies.

In a speech to the Association of Certified Fraud Examiners earlier this month, he said, "Companies that go public need to understand not only the benefits, but the responsibilities. It's not just a free ride."

The PCAOB's Niemeier seconds the view.

"I'm still trying to find investors who are worried about the costs of audit fees," he says.